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PAYMENTS ARRANGEMENTS FOR LESS DEVELOPED COUNTRIES: THE ROLE OF FOREIGN ASSISTANCE

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Payments Arrangements For Less Developed Countries: The Role of Foreign Assistance

Interest in payments arrangements for less developed countries has risen considerably in the last few years. In Central America, a clearing arrangement and a Monetary Stabilization Fund have been established among members of the Central American Common Market. Clearing arrangements exist among members of the Latin American Free Trade Association and among the three countries—Iran, Pakistan, and Turkey—of the Regional Cooperation for Development group, and two monetary unions have been established covering twelve former French territories in Central and West Africa. Proposals have also been drawn up for the establishment of a clearing arrangement and a multilateral reserve center in Asia under the auspices of the Economic Commission for Asia and the Far East. While the ECAFE countries have not reached a formal agreement on either of these proposals, there are indications that a clearing arrangement has the support of a number of countries in the area.

Recently the third United Nations Conference on Trade and Development (Santiago, April–May 1972), in its resolution on regional integration, recommended inter alia that "developing countries, where appropriate, promote . . . the establishment of suitable payments arrangements among themselves; . . . developed countries support such payments or monetary arrangements; . . . and the Secretary General of UNCTAD request the International Monetary Fund to consider the possibility of establishing a special facility to support trade expansion efforts among developing-country members of regional or subregional groupings." These recommendations raise policy questions about the role that developed countries or the International Monetary Fund can play in assisting the less developed countries in these efforts and the relationship of such assistance to overall development assistance from bilateral or multilateral sources.

The purpose of this essay is to examine the objectives of payments

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arrangements among the less developed countries, the issues that such arrangements raise, and their usefulness for attaining these objectives. The analysis will give special attention to the proposals now under consideration in ECAFE. On the basis of the analysis, the last section investigates the role that developed-country donors or the IMF can play in assisting the establishment and operation of these arrangements.

1. Institutional Alternatives

Until now consideration has focused on three basic kinds of monetary cooperation: (a) a simple clearing arrangement with a relatively short interval between settlement dates and the provision solely of interim credit (such arrangements are in force among members of the Central American Common Market and elsewhere and are proposed for ECAFE); (b) a payments union, where clearing is supplemented by a facility that provides medium-term credit to the participants; and (c) a reserve-pooling arrangement, which can range from simple agreements to pool a portion of total reserves and extend medium-term credit to participants to complete monetary union.

For each of these alternatives, there are variations with respect to specific features, such as the contributions of nonparticipants, the credit terms, the terms of settlement, the types of transactions covered, and the degree of monetary integration. This section discusses the three alternatives on the basis of both past experience with individual agreements and an analysis of some proposals that have not as yet been put into effect. The descriptive portions rely in part on the UNCTAD (1966) and Nowzad (1972) studies of payments arrangements. Readers familiar with the institutional features of payments arrangements might wish to omit this section and proceed directly to section 2.

Clearing Arrangements

A clearing arrangement is established among a group of less developed countries, usually within the same region, to provide an alternative to the existing payments network, which involves denominating transactions in some convertible foreign currency, such as dollars, francs, or sterling. This system substitutes a centralized arrangement of mutually compensated settlements for intragroup transactions, using an agreed-upon unit of account. Typically, this arrangement involves the extension of only interim credit up to certain predetermined limits. Settlement of net balances arising from trade and service transactions among the participants is made periodically in convertible currencies.

In the Central American Common Market (CACM) clearing arrangement, participants have agreed to extend credit up to $0.5 million to each member, with a six-month settlement period. If members exceed those limits, they must pay to other participants the excess in full in convertible currencies, unless a central bank agrees to increase the credit it extends. In the proposed Asian clearing union, each country would extend credit equal to one-sixth of its annual exports to participants and receive credit amounting to one-twelfth of its imports; the settlement period would be one month (Lee, 1972). In both instances, clearing would be voluntary for individual traders and a common unit of account has been established or proposed—the Central American peso in the former, the Asian dollar in the latter. Similar, if slightly less formal, arrangements have been established among the Regional Cooperation for Development (RCD) countries. The terms include a one-month settlement and a $2 million credit ceiling.

Among the members of the Latin American Free Trade Association (LAFTA) and the East African Community, agreements have also been reached for the establishment of reciprocal lines of credit. In addition to the basic clearing mechanism, LAFTA central banks agreed in 1969 to extend longer-term reciprocal lines of credit to be used by countries in balance-of-payments difficulties. The total initial amount of credit available was to be $30 million, but the agreement is not yet in force. In both these groups, the interim credit extended is less automatic than in the others discussed above, in the sense that it is based on the overall balance-of-payments and reserve position of the debtor, as well as the country's credit position within the group.

Payments Unions

While at present no payments union exists among less developed countries, the creation of such an arrangement has often been the subject of discussion and proposals, such as those by the UNCTAD Expert Group (1966) and the Pearson Commission (1969). The basic distinction between a payments union and a clearing arrangement is the provision of medium-term credit. The union could be based on mutual credit extended only among the participating members, or could be financed in part by outside contributors. The European Payments Union was such a mixed arrangement, with the United States contributing $100 million but not otherwise participating in the arrangement. The use of outside assistance allows creditors to be paid in part or in full, with larger credit extended to the debtors than would have otherwise been possible.

The apparent success of the EPU has led to repeated efforts to create similar institutions in the less developed countries. Some of the original proposals in the ECAFE region called for a payments union financed without outside credit (although the option of contributions from developed countries was left open), on the basis of initial positions. In a payments union based on initial positions, credit is provided only with respect to increments in trade among less developed countries. Thus, a less developed country would be asked to participate in the arrangement not with respect to all its trade, but only with respect to changes from the original position. How these original positions are established presumably would be subject to negotiations among the member countries. One approach would be to take a three- to five-year average prior to the establishment of the union.

None of the efforts to establish payments unions by less developed countries has succeeded to date, for reasons to be discussed later. Instead, in recent periods attention has focused on reserve-pooling arrangements.

Reserve Pooling

The most highly integrated system of reserve pooling at present is in the franc-area countries of Central and West Africa. These arrangements have involved the creation of two monetary unions—the West African Monetary Union and the Equatorial and Central African Monetary Union—using a common currency (the Communauté Financière Africaine franc), but each with its own central bank. The reserves of the participant countries are pooled in each case and deposited in the French Treasury, which guarantees the convertibility of the CFA franc into French francs, as well as unlimited overdraft facilities. If a country's imputed reserves in the pool become negative, the country pays a charge on the debit balance.

An arrangement involving far less monetary integration was established in Central America in 1970 in support of a regional common market. The Central American Monetary Stabilization Fund is, in fact, a partial pooling of reserves. Its objectives have been, first, to create a mechanism for mutual balance-of-payments assistance to member countries experiencing reserve losses as a result of short-term disequilibrium in the balance of payments, and, second, to contribute to the stability and broadening of the base for cooperation in trade and payments policy among the participating countries. In case of balance-of-payments difficulties by one of its members, the CAMSF can extend loans up to 75 per cent of the reserve loss in the previous twelve months

and subject to conditions designed to effect improvements in the country's balance of payments. Each of the five participants has agreed to deposit $1.5 million of its reserves in the Fund. In addition, the Fund obtained a loan from the U.S. Agency for International Development, swap arrangements with the central banks of Mexico and Venezuela, and lines of credit from American commercial banks, bringing its total resources to $77.5 million in 1972.

The proposed Asian Reserve Bank is similar to the CAMSF but somewhat more ambitious. It would serve the region much as the IMF serves the whole monetary system. Members would deposit 10 per cent of their official reserves with the bank and could borrow in case of overall balance-of-payments stringency. The basic differences are that the ARB would be able to borrow in convertible currencies; buy bonds issued by international organizations, such as the Asian Development Bank; and receive loans from nonparticipating countries. In addition, the following features of the proposals for the establishment of the bank are outlined in a recent ECAFE report (1972, pp. 7–8):

(a) All deposits will earn interest, comparable to the interest earned on deposits in major financial centers.

(b) Deposits will be denominated in an Asian unit of account, possibly fixed in value in relation to Special Drawing Rights.

(c) The Bank will be required at all times to maintain freely usable foreign exchange, gold and SDRs, equal to two-thirds of its deposit obligations. If such assets of the Bank fall below the minimum reserve position required, all lending and investing operations of the Bank will be halted until the minimum reserve position is restored.

(d) Member borrowing will be limited to one-half the decline in a member's official reserves during any one quarter. Within this limit, members may borrow, at an interest rate based on the rates prevailing in the major international financial centers, amounts up to their statutory deposits (i.e., ten per cent of their total official reserves) automatically. They may borrow more than their statutory deposit and up to twice that deposit if approved by a majority vote of the managing board. Borrowing beyond this latter sum requires approval of a four-fifths majority of the managing board.

(e) The full amount of any increase in a member's reserves subsequent to borrowing from the Bank must be repaid to the Bank. If this is not accomplished in three years' time, then the remaining balance must be repaid in full by contractual quarterly instalments extending over a period of not more than two years. In the event of a default, the facilities normally available to the member from the Bank will be suspended.

If all ECAFE countries had joined the scheme proposed for the region as of November 1971, the ARB would have had total assets of $2.3

billion, with $727 million available for lending or long-term investment.

The limit on the bank's reserve-creating capacity would depend on the bank's excess reserves. The bank's excess reserves, in turn, would depend on the total reserves of members and the proportion of these reserves that members were required to deposit with the bank, on any other deposits attracted from members or nonmembers, and on the ratio of required reserves to the bank's deposit liabilities. This limit could be increased by the bank's own short-term borrowing.

The ECAFE report (1972, pp. 9–10) expresses the view:

> [E]ventually, if the Reserve Bank operated efficiently and its liabilities became competitive with other reserve assets, members might deposit more than the sums required, increasing the Bank's lending capacity, as would non-member deposits, without increasing the automatic claims on that capacity. From this point it would be a short step to acceptance by members of the Reserve Bank's liabilities in settlement of intraregional payments deficits and the Bank would become more like a regional commercial bank.

2. Benefits and Objectives

The benefits that would presumably accrue to less developed countries from payments arrangements fall into four broad categories: improvement in the payments system, expansion of trade, increased ability to deal with short- to medium-term balance-of-payments disequilibria, and enhancement of the regional integration process.

Obviously, the relative emphasis each type of payments arrangement places on these objectives is likely to differ. Yet, in all instances, the arrangements are expected to result in increased regional cooperation and integration. In this section we will examine the extent to which the various types of existing or proposed payments arrangements have contributed in the past and/or can be expected to contribute in the future to the attainment of these four broad objectives.

Clearing Arrangements

Multilateral clearing arrangements will improve the payments system as well as promote trade expansion if international trade is hampered by bilateral agreements leading to the accumulation of inconvertible balances. This is not the case at present in trade among most developing countries. Unlike the situation prevailing in Europe prior to the establishment of the European Payments Union, the incidence of bilateral agreements in less developed countries is minimal. Trade among less developed countries is carried out in convertible currencies, primarily

dollars, sterling, and francs, through banking arrangements that the banks of these countries establish with banks in major financial centers (Mookerjee *et al.*, 1969).

While this conclusion may apply to the less developed countries in general, trade among certain subgroups may be inhibited by inadequate clearing and payments arrangements. Difficulties in obtaining conversion into foreign exchange and tardiness in clearing have been considered serious handicaps to expanded trade between the sterling-area and franc-area countries of West Africa, and more specifically between Niger and Nigeria, and Ghana and Upper Volta. Undoubtedly, in these instances of partial inconvertibility, improvements in the payments mechanism could be expected to encourage trade expansion, and clearing arrangements have been established among these pairs of countries. However, because of a large contraband trade carried out at black-market rates of exchange, the effects on trade expansion have not been substantial. Without appropriate exchange-rate policies, which would reduce the incentives for making payments through the black market, it is doubtful that a clearing mechanism based on the official rate can significantly increase trade.

Clearing arrangements are also likely to provide only very limited support to trade liberalization, because the interim credit they provide is by definition very short-term and its amounts are usually quite limited. Even if we assume that balance-of-payments difficulties of less developed countries inhibit trade liberalization, the provision of short-term liquidity by clearing arrangements is not likely to impel these countries to undertake trade-liberalization commitments (UNCTAD, 1970).

The conclusion that clearing alone will not provide a strong stimulus to the trade of less developed countries seems to contradict Vanek's (1966) assertion that these countries can derive considerable benefit from clearing arrangements even in the absence of accompanying forms of economic integration. Vanek's argument is that the overvaluation of the currencies of less developed countries makes it difficult for them to expand exports to each other or to third countries. He points out that less developed countries suffer from a scarcity of the hard currencies in which international trade transactions are denominated. Thus, while their currencies are not overvalued vis-à-vis each other (since they are approximately equally overvalued with respect to hard currencies), their trade is nevertheless discouraged by the fact that transactions are carried out in hard currencies. He then suggests that the creation of a payments arrangement with short settlement periods and interim credit would promote a vigorous expansion of trade among less developed countries:

"Under such conditions all the divergences in relative prices and costs imputable to over-valuation with respect to the hard currencies . . . will be eliminated, and trade generally will expand a good deal" (pp. 190–191).

It is difficult to share Vanek's enthusiasm for clearing arrangements as an instrument for trade expansion. First, the assumption of similar degrees of overvaluation of currencies is, as he also realizes, somewhat unrealistic. Developing countries vary drastically in the degree to which their currencies may be overvalued with respect to hard currencies. Second, clearing arrangements with interim credit *do not reduce* the need for foreign-exchange reserves to meet balance-of-payments contingencies. A participating country's net payments in gold and hard currencies are not affected, except in the very short term. Since settlement presumably is effected in hard currencies and the official (overvalued) exchange rate is used in the clearing, it is hard to see why the bilateral clearing arrangement would provide a stimulus to trade.

Finally, considerable experience with clearing arrangements among less developed countries suggests that little trade expansion can be traced to the arrangements themselves. This has been true for the Regional Cooperation for Development group (Iran, Pakistan, and Turkey) and for Latin America, where the ratio of regional trade to total trade has not increased significantly. The experience of the CACM is also instructive in this respect. Trade among the members of the CACM expanded at a very rapid pace in the period following the formation of the common market and clearing arrangements. The rate of growth of intra-CACM trade between 1960 and 1969 was 26 per cent per annum, compared with 6.5 per cent per annum for extraregional trade. However, this rapid growth in trade appears to have resulted primarily from the substantial preferential trade margins provided to participants in the CACM vis-à-vis outside producers and to the expansion of markets. The facilitation of payments through the clearing arrangement was responsible only to a very limited extent.

While clearing mechanisms may not provide either a significant stimulus to increased trade among the less developed countries or a substantial reduction in their foreign-exchange needs, these arrangements may still result in improvement in the payments mechanism of participating countries.

In the first place, the use of regional, as opposed to foreign, currencies for regional transactions may lead to some small economies in the use of foreign exchange. For example, a clearing arrangement may enable less developed countries to reduce the level of idle working balances

held with foreign banks. These balances are in convertible currencies maintained to finance day-to-day servicing of international transactions through foreign banks. Since transactions would be carried on through the clearing mechanism, the funds that members would have had to keep in foreign financial centers could be reduced, thus freeing some, *albeit small*, amounts of foreign-exchange reserves. How much would be freed is difficult to say, because less developed countries would still have to maintain balances to finance trade with nonparticipants.

Use of the clearing mechanism will also reduce the need for transfers of funds between accounts of less developed countries in foreign financial centers, such as New York or London, to settle individual traders' transactions, but the charges that foreign banks make for these transfers are small—around .25 per cent. The CACM clearing union, perhaps the most successful of these arrangements, has clearly achieved a significant increase in the use of the clearing mechanism for the settlement of regional transactions; about 85 per cent of all transactions among member countries are being handled through the clearing arrangement. In the Latin American Free Trade Association the proportion is 40 per cent, while in the Regional Cooperation for Development group it is barely 1 per cent. Assuming that clearing reduces fees in foreign exchange amounting to .25 per cent of each transaction and that all transactions cleared through the CACM between 1962 and 1970 had been cleared in London or New York, the member countries would have had to pay some $3.3 million in additional fees. Savings on these fees represent 1.2 per cent of the $267.5 million in reserves held by CACM countries in 1971. Thus, it would appear that the savings that could accrue to participants in clearing arrangements on account of the payments are likely to be small.

Clearing arrangements may result in some economies that accrue to traders in the participating countries but not to the countries as a whole. For instance, if transactions are carried out in the regional unit of account and participating countries deal in each other's currencies at par, this would reduce the conversion margin of the banks and hence the transaction cost to the trader. Traders would also benefit from not having to obtain forward cover, as transactions under clearing are normally covered under exchange-rate guarantees.

Finally, a clearing arrangement can undoubtedly prove beneficial in promoting consultation and perhaps even cooperation among central banks and monetary authorities in a region. Having noted this fact, it is difficult to say much more in assessing the importance of clearing arrangements relative to other forms of international cooperation. In areas where such arrangements have been established, they have followed or ac-

companied decisions to undertake important integration commitments but have not been the catalyst for such commitments. On the other hand, in regions where trade cooperation has proved difficult, the establishment of a clearing union might prove a useful first step. It is relatively simple to establish and operate and requires few commitments on the part of the participating countries. In Asia, where past integrative efforts have had little success, in part because the tremendous political and economic diversity of countries in the region made it difficult to undertake extensive trade-liberalization commitments, clearing appears to be a promising mode of cooperation.

An Aside—Worldwide Clearing for Less Developed Countries

The proposals of Michael and Frances Stewart (discussed in Lipton, 1972) for the establishment of monetary arrangements covering *all less developed countries* should be mentioned in the same context. The Stewarts start from the premise that prospects for exports from less developed countries to markets of developed countries are dim and that, for a variety of reasons, less developed countries ought to restrain imports from developed countries. This leads them to emphasize expansion of trade among less developed countries as a solution. The proposed monetary arrangements would then be an instrument to promote trade expansion, and preferential rates of exchange would apparently be used to provide a stimulus.

This is not the appropriate place to discuss the complex and far-reaching implications of the Stewarts' assumptions and argument. Nevertheless, some general observations are appropriate.

First, differential exchange rates would promote trade in the same way that a customs union does, except that the preferences would be granted through the exchange-rate mechanism rather than through tariffs. Thus, payments arrangements of this type are substitutes for, rather than complements to, trade liberalization through reduction of trade barriers. While preferential exchange rates might provide a strong stimulus to trade of less developed countries, their usefulness in this respect must be compared with the alternative way to attain the same objective—by providing preferential treatment to the tradable goods of other less developed countries. Since the differential exchange rates presumably would cover all transactions, their effects would be pervasive and similar to those of a customs union. These effects might be cushioned by the establishment of controls that would allow protection for certain countries or certain industries in order to enable them to compete with other participating countries. Despite this possibility, the establishment